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Love, Jim and Stevens, Jim (1986) Scottish steel at the crossroads. Quarterly Economic Commentary, 11 (3). pp. 61-65. ISSN 0306-7866 ,

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Economic Perspective 2

SCOTTISH STEEL AT THE CROSSROADS

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The 1980s have seen a continuation of the erosion of steel-making capacity in Scotland. Closures at Clydebridge, Cragneuk, Glengarnock and now Gartcosh have reduced not only the number of plants but also the diversity of the product base. Concern over the implications of the closure of Gartcosh, controversy over the SDA's advice to the Scottish Office, redundancies at Clydesale and fears about the plate operation at Dalzell have again concentrated attention on the future of the steel industry in Scotland. The purpose of this Perspective is to analyse the nature of the threat to the Scottish steel industry and set out the issues of relevance to BSC's 1988 review of its operations.

In the 1988 review BSC will seek to establish that configuration of plants which is consistent with both external and domestic trading constraints. Externally, the principal, direct determinant of market conditions for BSC is the regulatory framework imposed by the EEC. The EEC view international markets as being characterised by chronic overcapacity and strong protectionist sentiment. Most OECD countries are net exporters of steel to third countries. However, despite the emergence of a buyers' market many LDC's and Socialist States continue to expand steel capacity and subsidise production for strategic and development reasons. In addition there are adverse trends in European steel consumption resulting in part from policy-induced falls in public sector investment, substitution of other materials and lighter more compact product designs. Thus European steel producers face relatively stagnant home markets, limited access to US customers and intensely competitive and declining third markets where good margin business is difficult to generate in the face of low cost Japanese and Korean exports.

Such considerations prompted the EEC to introduce the Davignon Plan in 1980. Reinforced by the system of negotiated import restraints with third countries introduced in 1978, the underlying objectives of the Davignon Plan were those of achieving commercial viability free of state aids and of securing capacity reductions in the EEC such that by the end of 1985 EEC supply and demand should have been brought into line. To eliminate excess supply and to facilitate the necessary restructuring the Plan provided a system of production quotas and a system of subsidies. The Davignon Plan failed to attain its objectives and has been continued in modified form. Further substantial capacity reductions are required to achieve balance in the Community by 1990 although steel producers are currently in better technical and financial shape than in the early 1980's.

Domestically, the UK Government requires that BSC makes the industry commercially viable and that it prepares the industry for an as yet, unspecified privatisation exercise. It is pre-occupation with this requirement which now dominates strategic thinking within the Corporation.

BSC's strategy for the period to 1988 has been examined by the EEC in late 1985 and that examination led to two important conclusions. First, the Commission confirmed that the strategy, involving retention of the present five integrated plants including Ravenscraig, should permit achievement of viability in the three years to 1988. Secondly, the Commission agreed that the BSC restructuring plans, involving the acquisition and closure of the Alphasteel strip mill and the closure of a number of plants including the Gartcosh cold-rolling

mill, were eligible under Community law for state aid before the removal of eligibility at the end of 1985. This aid to BSC, as was announced in December 1985, amounted to £539m.

Much is made in official circles of the EEC conclusion that BSC will achieve viability by 1988 with all five integrated sites. This conclusion cannot be deployed, however, to suggest a necessarily more secure future for Ravenscraig. In the period to 1988 Ravenscraig's output is required while upgrading and refurbishment takes place in other plants. The central element in terms of any suggestion that BSC's commercial standing will support the retention of Ravenscraig thereafter is the definition of "viability".

This question of definition emerged in the 23 January Parliamentary debate on the closure of Gartcosh and highlighted the exacting influence of the privatisation objective. The new Secretary of State for Scotland, Mr Malcolm Rifkind, cited the Commission's report as saying that BSC "would reach viability in 1987/88 by meeting the Commission's target profit" (Hansard, 23 January, 1986, p.479), but he provided no definition of "target profit".

Subsequently, Dr Jeremy Bray (Motherwell, South) pointed out that:

"The BSC has adopted a milestone on the "road to viability".... The corporation calls it "financial self-sufficiency", that is, sufficient profits to cover interest costs, capital expenditure roughly equivalent to depreciation, and increases in working capital, but giving no return on equity". (Hansard, 23 January 1986, p.499)

The absence of any return on equity emphasises that this can only be an interim target in the face of the Government's determination to privatise the industry, a point pursued, *inter alia*, by Dr Bray and also by Mr Kenneth Warren (Hastings and Rye) Chairman of the Trade and Industry Select Committee. Mr Warren

favours privatisation but questions whether organisations such as Ravenscraig could ever achieve the requirements for privatisation thought to have been imposed on BSC by the Government. According to Mr Warren:

"My understanding to about a first order of accuracy, is that the Government are looking for a profit of £300 million on £4 billion worth of sales. That sounds pretty good. I hope that BSC can achieve it. If it can, it will achieve something that its prime competitors in other parts of the world, like Nippon-Kolkan, Nippon-Steel and Thyssen are simply not able to achieve. Those competitors are turning over profits that are about a half or a third of those that the Government expect BSC to make if it is to be a saleable commodity". (Hansard, 23 January 1986, p.490)

It is then reasonable to conclude that the conjuncture of the height of the Government's profit hurdle for privatisation and BSC's declared position that the viability and privatisation objectives cannot be met with three strip mills points ineluctably to Ravenscraig's closure.

Whatever the definition of "viability" applied to BSC's operations within the UK, the EEC now requires that steel-making activities be free of certain types of state aid. Having failed to meet the original Davignon objectives, the EEC now seeks to effect a transition to a less closely regulated market. After 1986 the EEC will sanction aid only for specific purposes such as research and development, environmental improvement and redundancy payments associated with plant closure. Operating subsidies are eliminated as are aids for other types of capital expenditure. These measures have the effect of ensuring that the profits necessary to privatise the UK industry have to be generated internally.

It is, however, important to recognise that while operating subsidies are

removed, indirect state subsidies remain permissible. These indirect subsidies affect costs over a range of inputs to steel-making including: energy; transport; continuing employee benefits such as pensions, health and income subsidies; labour costs such as retraining and relocation, taxes; and rates.

A recent study commissioned by the National Economic Development Office (NEDO) and conducted by Environmental Resources Limited sheds considerable light on the extent of these indirect subsidies in four European countries, France, Germany, Italy and the UK, and across a range of manufacturing activities including steel-making. After examining the main indirect state aids, the NEDO study concluded that three categories are of particular importance in the steel industry: namely, aids to transport, continuing employee benefits and labour costs. Excluded from consideration, however, were indirect subsidies to energy. This exclusion is significant, given the widespread suspicion that European Governments provide subsidies for electricity and, particularly in the case of Italy, for coking coal.

The question of energy subsidies has been brought to Government's attention on numerous occasions. In 1984, BSC Chairman Robert Haslam told the trade and Industry Select Committee:

"Electricity prices are important and if you reflect on the best comparisons we can make, and these are not by any means fallible, the German prices and the prices in Holland are probably 5% to 10% lower than ours. These comparable prices move with exchange rates all the time and figures reflect current rates. In France it will be 20% lower than ours. In Germany you may have particular situations which may enjoy even greater benefits." (Cmnd 344 p340)

He added:

"Energy in Germany is for major steel plants considerably cheaper because beneficial prices can be focussed there. This would not happen in this country because of our anti-discrimination culture." (Cmnd 344 p376)

There is little to suggest that this situation has improved materially. It should be noted that current exchange rates are similar to those prevailing when Sir Robert Haslam gave this evidence and that BSC executives have underlined these points on several occasions in the intervening period. In 1984, the Government did not accept this analysis. The DTI responded by admitting that some Continental steelmakers enjoy electricity charges up to 15% lower than those facing BSC. However, they would not concede that "the generality of steelworks on the continent are paying less than BSC" (Cmnd 344 - Further Memorandum submitted by the Department of Trade and Industry).

Table 1 State aid to the steel industry

	France	Germany	Italy	UK
Total aid	130.7	244.3	123.0	14.4
Reductions of steel costs £/tonne of steel	8.3	8.0	6.0	1.2
Costs reductions £/tonne of steel BOP	7.03	6.78	6.05	0.63

Source: NEDO, Indirect Aids in the EEC and their Impact on the EEC Steel Industry, Environmental Resources Limited, Economics and Policy Unit, September 1985.

The main findings of the recent NEDO report are summarised in Table 1. Several observations can readily be made on these findings. First, in absolute terms the total aid given to the UK steel industry falls very far short of that given in the other three countries. Given differences in output levels, however, it is necessary to consider not the absolute value of aid but rather the impact on cost reduction per tonne of steel output. This reduces the scale of the disadvantage apparently experienced by the UK industry. Nevertheless, the cost reduction in the UK is only one-fifth of that enjoyed in Italy and almost one-seventh of that enjoyed in France. More interestingly with respect to Ravenscraig, the NEDO study also considered the cost reductions to basic oxygen producers

(BOP). Here the UK cost reduction is only between almost one-tenth and one-eleventh of that in the three other countries. Generally, therefore, steel-makers in other countries benefit from indirect to a greater extent than in the UK.

The relatively low level of UK subsidy to the steel industry is consistent with the Government's free-market philosophy.

Undoubtedly, however, while the EEC is moving to a free market, that market is not a free market. Domestic UK policy places BSC at a cost disadvantage of £5 to £8 per tonne even without account being taken of subsidies to energy, a potentially damaging margin as EEC producers seek to increase their market shares in the liberalised market of the late 1980s. Unfortunately the Commission have a curious outlook on such matters. In 1984, Viscount Davington told the Trade and Industry Select Committee that:

"The Commission do not take account of indirect subsidies, partly because it is too complicated, but basically because the Commission do not think that they create distortions which will significantly affect the competitiveness of firms."

(Cmnd 344 - Note of the Meeting of the Committee with Viscount Davington)

Two comments are opposite. First, as of November 1985 the EEC still adhered to this view. Secondly, the publicly available evidence on both energy and other costs indicates that the EEC position is at odds with reality and is potentially damaging to the Ravenscraig complex.

In 1984, the BSC Chairman Sir Robert Haslam discussed the closure of an integrated plant in very frank terms by indicating to the Trade and Industry Select Committee that: "Our view would be that any closure would be phased and hence an immediate closure would be unlikely". (Cmnd 344 p57).

The closure of Gartcosh may be seen as one of these phases. As argued in previous **Commentaries**, a number of now well-rehearsed factors continue to point to Ravenscraig's closure. First, BSC has persistently argued that the objectives of commercial viability and privatisation are inconsistent with a 5 plant configuration. Unfair competition from indirectly subsidised European competitors and continuing adverse market trends reinforce this conclusion. Secondly, the purchase and substantial refurbishment of Alphasteel's continuous casting facilities for eventual installation at Llanwern will remove Ravenscraig's technological advantage in the production of high quality strip products. This renders Ravenscraig more vulnerable to BSC's long-standing desire for closure on locational grounds. The locational savings derived from the Gartcosh closure were minimal which suggests that the bulk of such economies are still to be realised. Thirdly, the Shotton linkage is not a source of long-term security given BSC's well-stated position that they can and must load all of their rolling mills from four plants. At present BSC require Ravenscraig's concast product in order to facilitate their drive to increase market penetration in the coated strip sector. By 1988 this necessity will disappear as the enhanced facilities of Llanwern come on stream. In addition, BSC now openly admit that there is an option of supplying Shotton from the Lackenby Complex on Teeside. Thus, by the end of the decade BSC could easily do without Ravenscraig's strip output. Fourthly, the decision to undertake no investment in coke ovens at any UK works will bite first at Motherwell because of the relative age of the capital stock. This will force BSC to purchase scarce and expensive coke at the beginning of the next decade which allied to the adverse effects on the plants energy balance, will raise Ravenscraig's costs. Given the need to generate investment capital internally and the backlog of process innovations available to BSC, it is not difficult to foresee the Corporation seeking closure to avoid the commitment of funds to its perceived marginal unit. Fifthly, Ravenscraig is vulnerable to any misfortune in any sector of BSC's bulk steelmaking activity. The strip division has recently undertaken a major policy review which culminated in increased investment and employment in Wales and the closure of Gartcosh.

As indicated above, Ravenscraig's strip operation looks extremely marginal and

vulnerable to any deterioration in BSC's share of home markets or failure to maintain export volume. Unfortunately, the new flexible quota system makes it possible for North European strip producers to capitalise on BSC's planned temporary reduction in supply of concast cold reduced non-coated products. In addition, however, Ravenscraig is threatened in the medium-term by uncertainty over the future of the Dalzell plate mill. Although situated adjacent to Ravenscraig, Dalzell is not part of that integrated complex. In organisational terms, Ravenscraig is part of BSC's Strip Division while Dalzell is part of BSC's General Steels Division. Ravenscraig supplies Dalzell with input in the form of concast slabs and a small proportion of conventionally cast ingots.

Since the closure of the Hartlepool plate mill in 1984, BSC is left with only two plate mills, at Dalzell and Scunthorpe. Both mills are small in capacity terms by European and Japanese standards and cannot produce wider specifications. Indeed, these mills were developed in the 1960s and 1970s to serve the shipbuilding industry, a market which has shrunk dramatically in recent years. Whilst clearly the better of the two BSC plants, Dalzell is underpowered and poorly laid out which results in output being only 50% of that of European mills of similar design and vintage. However, owing to Ravenscraig's high quality steelmaking facilities and an innovative, but costly, alloying process, BSC is able to compete with more modern and suitably furnished plate mills in the exacting specialist plate, defence and oil-related markets.

Market projections for plate are not good. The EEC estimates that substantial excess capacity of 4.7 million tonnes (33.3%) exists and suggests that further capacity reductions are urgently required by 1990. A high proportion of Dalzell's output goes to the local offshore construction sector. However, the prospects for North Sea exploration and development are uncertain. Until recently industry analysts were projecting a mini boom in activity over the next three years, but developments in world oil markets have promoted increasing pessimism and several fabricators, such as Trafalgar House, have recently scaled down their estimates of future orders.

Were BSC to invest in a modern plate mill, either one or both of their present operations would have to close because a plate mill built to modern standards and design would be able, in all probability, to handle BSC's likely share of this market. Consequently, Dalzell, and, indeed, the Scunthorpe mill are vulnerable in a strategic sense to BSC's necessity to modernise its infrastructure.

From a Scottish perspective, it is ominous that BSC executives have referred to the plant as "an ageing platemill" and have refused to sanction any major investment at the Motherwell site. More worrying are recent reports that General Steel's executives are preparing a case for the installation of secondary steelmaking facilities at both Lackenby and Scunthorpe. At present such facilities provide Ravenscraig-Dalzell with unique access to BSC's specialist defence and oil-related markets. In addition, General Steels are currently reviewing the plate-making operation and are believed to have isolated 3 options involving a new mill at either of the present locations or at a site in the North East. It would appear that BSC may be clearing the ground to eliminate their dependence on Dalzell for quality plate production. Dalzell currently accounts for around 20% of Ravenscraig's output and loss of that customer would greatly exacerbate Ravenscraig's precarious position. Decisions on plate production would seem a legitimate concern for Government given that a plate closure would jeopardise the present five plant strategy.

In the January debate in the House of Commons the Secretary of State commented that "without any qualification..... "I attach great importance to Ravenscraig and to the viability of the Scottish steel industry" and continued "I believe that the Corporation can achieve viability with the continuation of all its five plants". (Hansard, 23 January 1986, p482). Given present and likely circumstances, however, there are grounds for considerable concern and the task of retaining Ravenscraig after 1988 looks at least as formidable for Mr Rifkind as it was for Mr Younger in 1982.